DOW THEORY LETTERS INC.

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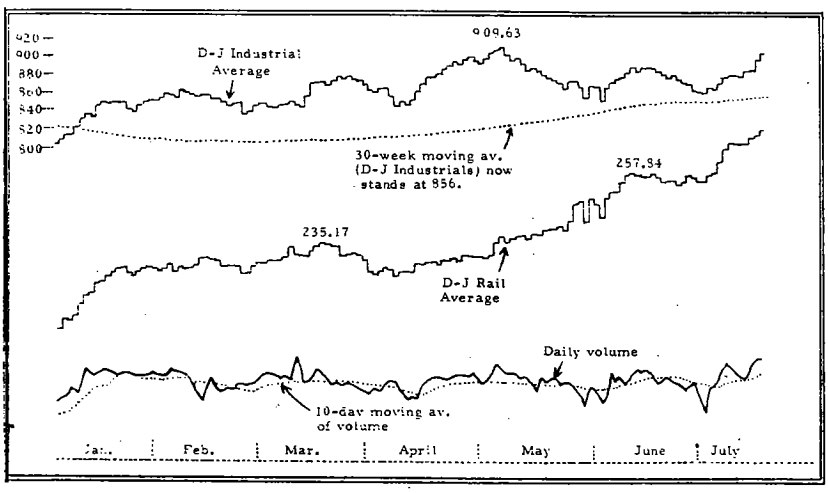
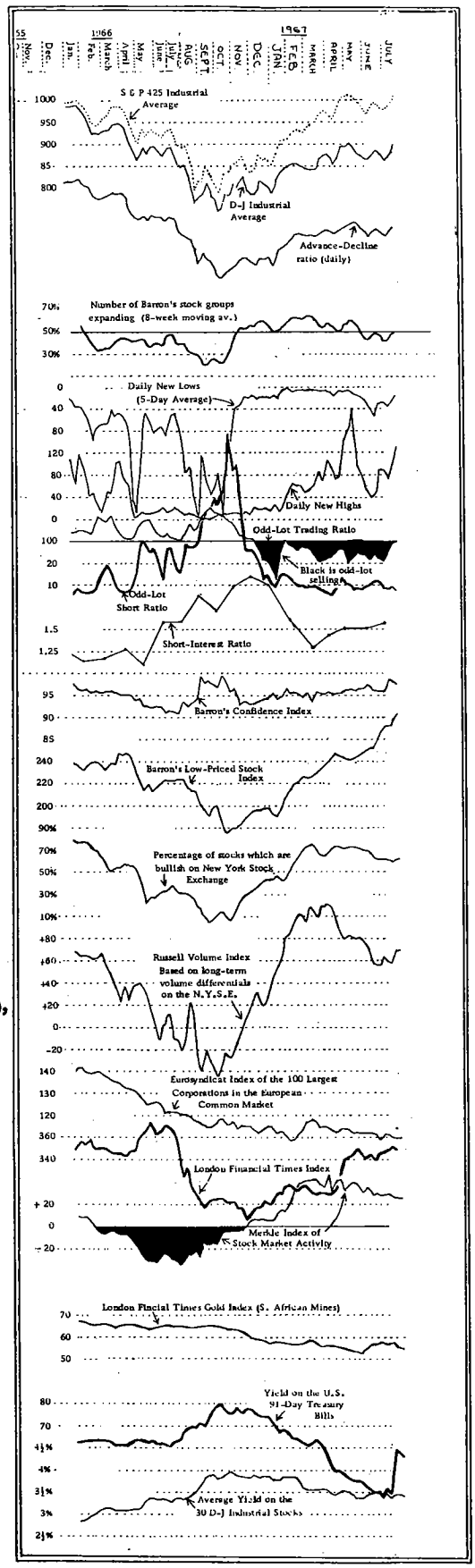
THE MARKET: Last week Barron's Low-Priced Stock Index hit a record high of 287.4 amid the wildest speculation this observer has ever seen. With volume on the Amex again running about 50% of that on the N.Y.S.E., the high-grade stocks strained while the "cats and dogs" continued to put on their frenzied pyrotechnics. What is prompting people to jump into this market and run up the "garbage" stocks? For one thing, the Johnson Administration is lending tacit encouragement to the speculative atmosphere by refraining from issuing warnings. Indeed, everything out of Washington is calculated to keep the pot boiling. Good news is played up, adverse news is softened, economic estimates are boosted (and adjusted later), and all the while the nation is being flooded with money. It is one of the most cynical and devious performances I have ever seen, and veteran students can only watch, shake their head, and wonder about the aftermath of this "hopped up" and "hypo'd up" financial party.

It is ironic to me that this most intense of all speculation should come within the first major advance in a primary bear market. If someone had told me, five years ago, that this is where the greatest speculation would come, I would not have believed it. But a number of factors have come together to produce today's almost fatalistic attitude towards stock speculation. For one thing, people and corporations are being squeezed as costs go up and business becomes increasingly competitive. Many people need extra money just to cover the cost of living. The squeeze is everywhere. The wish to "make a quick buck" on the Wall Street gravy train has become almost overwhelming. During the last few weeks many people have called to ask me whether I have any "reliable" source of hot tips and "winners." I have not heard anything like this since 1961.

Secondly, the Administration (I believe) senses economic trouble on the horizon, and consequently it will avoid anything which might even vaguely upset Wall Street. The Administration feels that the boom on the Street is a hopeful indication, and it is praying that business will follow.

Finally, the public has swallowed its skepticism and has accepted the view that this is indeed a "managed" world. The news is managed, the economy is managed, money is managed, the war in Vietnam is managed, politics is managed, so why worry? If the Government wants business to boom (particularly for the 1968 elections),




1966
1967
S & P 425 Industrial Average
D-J Industrial Average
Advance-Decline ratio (daily)
Number of Barron's stock groups expanding (8-week moving av.)
Daily New Lows (5-Day Average)
Daily New Highs
Odd-Lot Trading Ratio
Black is odd-lot selling
Odd-Lot Short Ratio
Short-Interest Ratio
Barron's Confidence Index
Barron's Low-Priced Stock Index
Percentage of stocks which are bullish on New York Stock Exchange
Russell Volume Index Based on long-term volume differentials on the N.Y.S.E.
Eurosyndicat Index of the 100 Largest Corporations in the European Common Market
London Financial Times Index
Merkle Index of Stock Market Activity
London Fincial Times Gold Index (S. African Mines)
Yield on the U.S. 91-Day Treasury Bills
Average Yield on the 30 D-J Industrial Stocks

why fight it? The Government has become all-powerful and who wants to bet against (or even insure against) Federal policies which are directed towards keeping everything in an ever-upward direction? You cannot blame the public. Those who have bet against Government intentions over the past 17 years have come out again and again on the "short end of the stick."

If there is any skepticism at all, it is appearing in the investment areas of this market. The bond market has caved in to protect itself against coming problems in financing the national debt, a dept which is looming ever mountainous. Blue-chip stocks (and the D-J Industrials) have followed this speculative move in a most sluggish manner. Since May 8, the D-J Industrials have failed to confirm the new recovery highs registered almost daily by the Rail Average, while the Utility Average has flirted persistently with its recent low for the year. But even this performance (which historically is an ominous one) is explained away. If there is a ride left in this market (be it a week or a month), the public and the speculators are ready and willing to climb aboard. Historically large (negative) yield spreads between stocks and bonds failed to slow the speculation. Hysterical action in junk stocks is greeted with enthusiasm. The very thesis of this being a rally in a bear market is forgotten.

NOTES & QUOTES: The "break-even" point in N.Y.S.E. volume for 1966 is now 5.9 million shares, highest in history. This means that member firms now require an average of 5.6 million shares each day in order to break even on operating overhead. The break-even point in 1965 was 4.8 million and the point in 1964 was 4.1 million shares per day. The 1966 jump was the largest since the survey was started in 1952. Said Exchange President Keith Funston, "The disappointing margin of profit would seem to justify our concern over the long-range profitability of the security-commission business."

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No one yet knows what the Vietnam war is costing. The Assistant Secretary of Defense has recently stated that the war will cost $21.8 billion in the fiscal year starting this month. Joint Economic Committee Chairman Proxmire estimates the cost for the year at $25 billion. The Congress is upset by the complete vacuum regarding accurate knowledge of how much spending actually is going on. The Administration is being purposely hazy, fearing the impact of accurate estimates. President Johnson's original estimate for the cost of the war in fiscal 1967 was $10 billion. That estimate turned out to be $12 billion short!

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The spot price of the pound sterling dropped on July 14 to $2.786, another new low for the year (see Letter 362). Thus the steady pressure continues unabated. The only difference between this situation and those that existed before: nobody is talking about it this time. A curious euphoria or perhaps fatalism seems to have blanketed the situation. Last week British Government bonds dropped to new lows for the year (bringing new highs in interest rates). This could be the British bond market's way of protecting itself against a coming defense of the pound. One of the ways the pound might be defended is via another series of boosts in the British bank rate.

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Last week the D-J spot and future commodity indexes broke to lows for the year. Such weakness in commodities in wartime has never before been seen. What is happening? Obviously, the sensitive commodity market does not believe in the much-touted business which is supposed to materialize during the latter half of 1967. Economist Eliot Janeway (who is bullish on the coming level of business) makes the following comment in his July 11 Janeway Letter: "We have no doubt that the American business picture is going to improve substantially when and as present auto labor uncertainties are resolved, and no matter how seriously the deterioration of money conditions may retard residential building. But until the business improvement actually arrives, commodity markets are going to remain resistant to normal speculative urges." This writer continues to believe that there will be no great improvement in business (the bear market should take care of that).

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According to S.E.C. figures, corporate profits per dollar of sales dropped from 5.6¢ in the last quarter of 1966 to 4.6¢ in the first quarter of 1967. The second quarter figures promise to be as bad or worse. The corporate profit squeeze is on, and this is documented in the last issue of Dow Theory Economics Trends Letter. Adding to the squeeze will be higher interest rates and higher labor and material costs from here on. Yet because of still domestic sluggish sales and because of the "dry rot" which has enveloped the European economies, it is going to be increasingly difficult to pass on the cost increases in the form of higher prices for goods. The larger the corporation and the broader its spectrum of activities, the less likely it is to escape the profit squeeze. This could be one of the explanations behind the poor performance of the Dow Industrials.

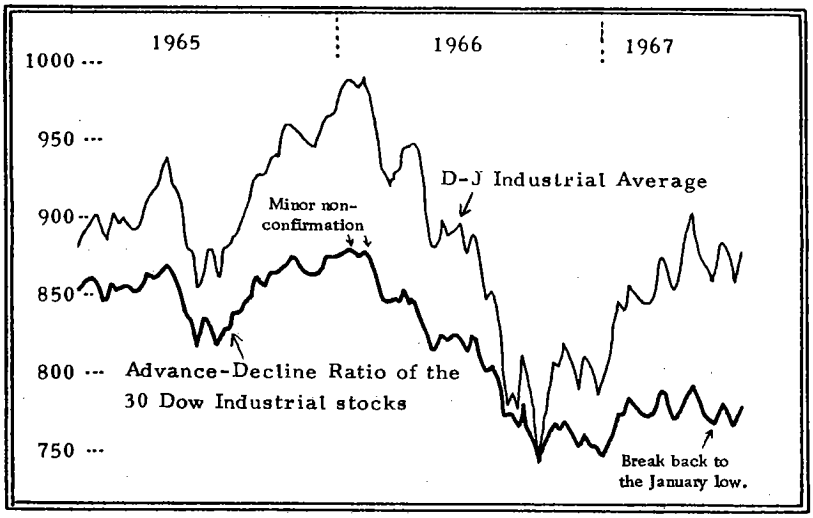
So what will the outcome be? In my opinion, this market will coast right over the precipice, and when it does, panic conditions will prevail over-night. Remember, every major primary bear market in history has ultimately entered a period in which trading has become disorganized, in which good sense finally overrides pipe dreams, and at such times everyone is prompted to swap their stock certificates for cash and make for the exits. My bet is that this type of action will be seen between now and late fall. It could happen in a week or a few months. But when it occurs there will be little or no support under this market. It will crash as have all preceding primary bear markets crashed. Following that, conservatism will take over in Wall Street. Today's voracious speculation will be seen for what it is, a last blind bubble of enthusiasm before the advent of reality.

I am continually amazed at the increase in our business here during 1967. Even though I have been cautioning against entering the speculative whirlpool, even though this advice has been repeated in the face of unbridled bullishness on the part of brokerage houses and other analysts, our subscriptions have jumped 25% ahead of the 1966 period. Do I have the most intellectual subscribers in the business? Are readers following me as a sort of financial "conscience"? I don't know, but I would guess that deep in the heart of most sophisticated investors today, there is a strong suspicion that I am right. They know that a meteor often burns brightest just before it dies and falls to earth.

I urge subscribers to treat this explosive rally within a bear market with utmost caution. We are drawing nearer and nearer the moment of truth. History dictates that the best policy is to stay out of a primary bear market, to avoid the rallies and the primary declines, and to save one's cash for the great bargains which will show up inevitably at the bottom.

DANGEROUS: The D-J Industrial Average is an average of 30 giant investment-type issues. It is our most convenient gauge of the blue-chip sector of the market. During all the recent furor it was interesting to see how these 30 stocks acted. At the May 8, 1967 peak the Dow touched 909.68, which represented roughly a two-thirds retracement of the entire 1966 decline. This retracement was more or less typical of what might be expected during a powerful secondary (upward) reaction in the second phase of a primary bear market. Remember, it is in the second (psychological) phase of a bear market that one can expect a violent correction to appear. The second phase, historically, is always the most deceptive phase of a bear (or a bull) market, and readers were warned in 1966 to expect surprises (both on Wall Street and in the economy) during the second phase.

I am indebted to Mr. Charles Carden of Fort Worth, Texas for the statistics on the advance-decline ratio for the 30 Dow stocks. I thought the accompanying chart was most informative. This chart shows the path of the Dow Industrials (Friday closings) together with an advance-decline line for those 30 stocks. To illustrate, if 20 Dow stocks rise for a given week and 10 decline, the Dow A-D ratio would register a plus 20 for that week.



Note that the Dow and its A-D ratio stayed pretty much in gear during 1965. In early 1966 weakness appeared as the A-D ratio barely managed to reach its earlier 1965 peak, despite new historic highs in the Dow. The final February, 1966 peak in the Dow was unconfirmed by the A-D ratio. Following this the market caved in with both indicators heading down in gear.

The advance which began in October, 1966, was characterized by persistent weakness in the Dow A-D ratio. The ratio edged sluggishly sideways during most of 1966, but it did record a peak on the week of May 8 along with the Dow. But during the four weeks which followed, the Dow A-D ratio broke sharply. By June 4, the A-D ratio had succeeded in wiping out all its gains back to the early January, 1967 period. Aside from the weakness which this portrayed, the formula was thereby set up for technical trouble. For in view of the sloppy performance of the Dow A-D ratio during 1967, it is now almost certain that any new recovery highs in the Dow (if they occur) will not be confirmed by the Dow A-D ratio.

Thus, this whole study underscores the outstanding weakness in the blue-chips, and the situation is rendered doubly dangerous by the manner in which the speculative sector is now completely ignoring the trouble in the investment sector of the market. It is a classic case of the "junk" fiddling while the blue-chips burn.

QUESTION: You have advocated holding U.S. Treasury bills. But these yield only slightly above 4%, even after their recent sharp yield rally. What is wrong with buying Certificates of Deposits from good banks? These yield 5% or slightly better in many cases.

ANSWER: Treasury bills constitute the first call on the taxing power and assets of the U.S. Government. They can be purchased for any maturity: 5 days away, a month away, or the full maturity of 91 days away. They constitute the ultimate in liquidity and to all purposes are tantamount to cash.

Certificates of Deposit (C/D's) are insured up to $15,000 by the Federal Deposit Insurance Corp., an agency of the U.S. Government. Many banks now pay up to 5% for 6-month C/D's. For instance, Security First National here in California pays 5% for C/D's of 6-month maturity. This money must be held on deposit 6 months and no interest will be paid if the money is withdrawn before the stipulated 6 month period. After 6 months, however, interest is paid at 3 month intervals. I see nothing wrong with placing money in C/D at leading banks. But it is simply a question of how safe one wants to be. The ultimate safety lies in Treasury bills and the ultimate liquidity is also in bills. I feel it's a question of whether one wants to be 98% safe instead of 90% safe. In a world monetary crisis, there could conceivably be a time delay in cashing in C/D's whereas bills would be paid off immediately.

QUESTION: I am worried about the weakness in the pound and the continuing deficit in the U.S. balance-of-payments. If devaluation comes in Britain and then here, or even to both countries together, how will I be affected?

ANSWER: This is a most difficult question, and it entails mass psychology, the hardest thing in the world to predict. But in general, I feel that a devaluation would not affect the average U.S. investor in real terms immediately. If the U.S. devalues by say halfing the value of the dollar in terms of real money (i.e., gold), then in terms of purchasing power the American would not be affected in terms of his domestic purchases. A dollar would still buy one dollar worth of groceries. However, it would then take twice as many dollars to buy a Volkswagen, assuming the German mark could resist a U.S. devaluation. And in turn, Germans could purchase twice as much in the U.S. with stable marks. In other words, in international trade the U.S. would assume a tremendous devaluation advantage (such an advantage that Germany and all other countries would probably be forced to devalue also).

If Americans wish to hedge against the possibility of foreign currencies holding out in the face of a unilateral U.S. devaluation, they would have to own gold shares or foreign assets such as foreign currency. The easiest hedge for the average American would be a position in gold shares, since these shares would advance tremendously during a devaluation simply because the selling price of their product, gold, would rise while costs would remain relatively stable.

All in all, I feel that the only hedge the average investor needs in terms of possible devaluation is a 10% or 15% position in such stocks as Western Deep Levels, Dome Mines and American-South African. The potential rise in such issues during a devaluation would constitute an important hedge. But I feel that the average American would nevertheless find his buying power in terms of domestic goods little affected by even a unilateral U.S. devaluation.

COMMENTS: I have been flooded by extension subscriptions via the special offer in last week's Letter. Many included personal letters, and I must apologize for not being able to answer each of these. I simply do not have the time to get out these reports and answer all the letters I would like to answer. But to all who wrote, my heartfelt thanks.

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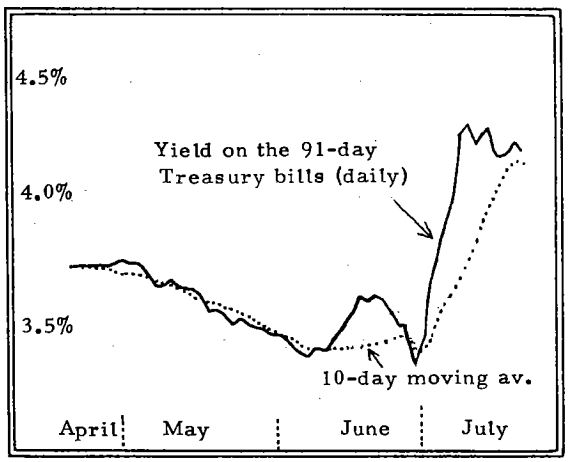
Many pleasing comments have arrived regarding the Economic Trends Letter. Some subscribers said that it contained information which previously required subscriptions to two or three other services, and this will permit them to reduce their costs considerably over coming years. Others commented that the new addition served to make the entire service doubly valuable to them. I want to add one thing about which there may be some misunderstanding. Mr. Holzman's comments and opinions are strictly his own. His opinion about the market or about the economy may differ radically from mine at any time. He is under absolutely no obligation to agree with me, and I would not have it any other way. Obviously, however, if I see him splitting an infinitive I will put my foot down.

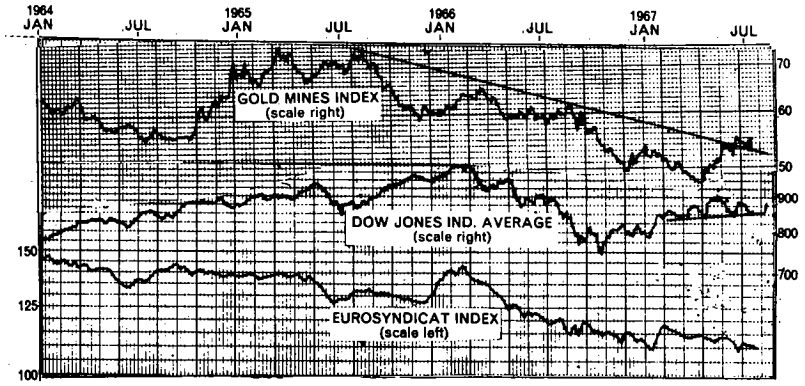
EXPLOSION: In January, President Johnson promised the nation via TV: "I pledge the American people that I will do everything in the President's power to lower interest rates and to ease money in this country." No one can say that he didn't try. The Federal Reserve has been buying massive amounts of bills and bonds in an effort to raise the price of those instruments and thereby lower their yields. First they bought bills and that held the bill rate down in the 3.4% yield zone. Then the Fed bought bonds, but the market forces proved too strong and Treasury bonds sagged to historic lows (and highs in yields).



Then three weeks ago the Treasury announced the Government's plan to borrow $6.2 billion in the short-term bill market. This was to represent less than a third of the borrowing needs of the next six months. The announcement proved too much even for the manipulated bill market, and the accompanying chart shows the explosion which has occurred in bill yields. This is a daily chart of the bill yields (the dotted line is a 10-day moving average).

So the surge in money rates is now complete. It has hit the long-term and the short-term market. Investors can now obtain better than 4% yields on Treasury 91-day bills again, and this represents perhaps the safest and most attractive investment for the average person today. From a yield of 3.4% only two weeks ago, the Treasury bill yields (91-day bills) rallied to 4.28% on July 2. It was one of the sharpest sell-offs in Treasury bills in history.

COMPARISONS: The accompanying chart is courtesy of Security Analysts (354 Kennington Rd., London S.E. 11). Here we see three years of price action in the Dow, the Eurosyndicat Index (comprising the 66 largest Common Market corporations) and the Index of South African gold mines.



I thought the comparisons were most interesting. Europe is in trouble, and we see this in the long, extended bear market decline in the Eurosyndicat Index. The Dow, following its 1966 smash, has rallied into the 880-900 area again, but at what cost? The U.S. Government has flooded the economy with money, and in the face of this the U.S. gold ratio has dropped to 31.3, lowest level of the year.

Meanwhile, sophisticated investors around the world are seeking to protect themselves against the coming monetary storm. This is underscored by the 1967 reversal in the gold index, and more recently by the Gold Index's upward penetration of the descending trendline which has held in force since mid-1966. On July 18, as the pound sterling dropped to a new 1967 low, assorted S. African mining shares jumped sharply. The battle lines have formed. Europe is protecting itself while the U.S. is embarked on a speculative binge. The remainder of 1967 should provide a most interesting financial spectacle.